FILE COPY

FILED
MAR 9
CHARLES ELMORE

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1931

No. 575

NORTH AMERICAN OIL CONSOLIDATED
(a corporation),
Petitioner,

vs.

DAVID BURNET, Commissioner of Internal Revenue,
Respondent.

MEMORANDUM FOR THE PETITIONER,
(Supplementing Brief in Support of Petition.)

HERBERT W. CLARK,
Crocker Building, San Francisco, California,
Attorney for Petitioner.

Table of Contents

	Pages
Questions presented	1 - 4
Argument:	
Point 1. Unconditional right to income is not a condition precedent to accruability of income	4 - 10
Point 2. If unconditional right to income is at foundation of right to accrue, then it would seem to follow that unconditional right and not mere claim of right must exist to render income taxable as cash income	10 - 17
Point 3. None of cases relied on by Circuit Court of Appeals sustain position of that court	17 - 24
Conclusion	24 - 25

Citations

Cases: Pages

Aluminum Castings Company v. Routzahn, 282 U. S. 92, 99 10

Brown v. Commissioner, Circuit Court of Appeals for the First Circuit, decided December 17, 1931 ..... 12, 17
Brunton v. Commissioner, 43 F. (2d) 81, 82 10
Burnet v. Sanford & Brooks Co., 282 U. S. 359 ..... 13, 17, 18, 19

Commissioner v. Garber (C. C. A. 9) 50 F. (2d) 588 ... 19, 22, 24
Converse v. Hamilton, 224 U. S. 243 8

Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185 5

Eckert v. Burnet, 283 U. S. 140 ..... 19, 21
Eisner v. Macomber, 252 U. S. 189, 207 ..... 5, 11, 19, 20

Grant v. Mutual Life Insurance Co., 106 U. S. 429 8

Herold v. Mutual Benefit Life Ins. Co., 201 Fed. 918 .... 19, 20

Kentucky & Indiana Railroad Co. v. Commissioner, Circuit Court of Appeals for the Sixth Circuit, decided December 18, 1931, 54 F. (2d) 738 ..... 12, 14

Lucas v. American Code Company, 280 U. S. 445 .... 4, 7, 9
Lucas v. North Texas Lumber Co., 281 U. S. 11 ..... 7, 19, 21

Maryland Casualty Co. v. U. S., 251 U. S. 342 ..... 19, 20

Obispo Oil Co. v. Welch, Collector, 48 F. (2d) 872, 875 .. 8

United States v. Anderson, 269 U. S. 422, 437, 438 .... 6, 11, 20
United States v. Northern American Oil Consolidated et al., 242 Fed. 723 2
Universal Battery Co. v. U. S., 281 U. S. 580, 584 .... 10, 17

Statutes:

Revenue Act of 1916, c. 463, 39 Stat. 756, Section 13 (d) 5
Revenue Act of 1917, c. 63, 40 Stat. 300, Section 13 (d) 5
Revenue Act of 1916, Sections 12 (a) and 13 (d) 6

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1931

No. 575

NORTH AMERICAN OIL CONSOLIDATED
(a corporation),
Petitioner,

vs.

DAVID BURNET, Commissioner of Internal Revenue,
Respondent.

MEMORANDUM FOR THE PETITIONER.
(Supplementing Brief in Support of Petition.)

Certiorari was granted herein on January 25, 1932 (R. 205), to review a judgment of the Circuit Court of Appeals for the Ninth Circuit (R. 194-203; 50 F. (2d) 752), reversing a decision of the Board of Tax Appeals. (R. 130-145; 12 B. T. A. 68.) All points made in Petitioner's brief in support of the petition

for writ of certiorari are reasserted. This memorandum is intended to supplement that brief.

The nature of the proceedings is set forth at pages 2-4 of the petition for writ of certiorari, and a summary of the matter involved appears at pages 4-9 therein and at pages 2-4 of the **Memorandum for the Respondent.** Although not expressly found as facts by the Board of Tax Appeals, reference to the report of the case of *United States v. North American Oil Consolidated, et al.*, 242 Fed. 723, which is incorporated in the Board's findings by reference (R. 120) discloses, as additional facts, that prior to and on January 1, 1916, and therefore before the date, February 3. 1916, of the order appointing the receiver in the above entitled case, applications for patent to Section 2, Township 32 south, Range 23 east—the land as to which the receiver was appointed on February 3, 1916—were pending in the United States Land Office. (R. 124.) It was upon and pursuant to these applications that the patent of 1922 was issued after the Supreme Court dismissed the Government's appeal. (R. 128.) Moreover, on various dates after May 4, 1910, and before the commencement of *United States v. North American Oil Consolidated, et al.*, supra, oil in commercial quantities had been discovered on each quarter section of Section 2. (See 242 Fed. 723, 726.) The two questions raised in the case of *United States v. North American Oil Consolidated, et al.*, were: (1) On September 27, 1909, the date of the withdrawal order, was the claim of Section 2, "a location or claim existing and valid," and therefore

excluded from the operation of the withdrawal order? and (2) was the Pioneer Midway Oil Company (which was a predecessor in interest of this Petitioner) an actual bona fide occupant and claimant of section 2 on September 27, 1909, for the purpose of acquiring title under the mining laws, and then in diligent prosecution of work leading to discovery, within the meaning of the Pickett Act?* The District Court answered the second question in the affirmative and, in consequence, found it unnecessary to answer the first. And, as we have stated at page 6 of the petition herein, the Government's bill was dismissed on June 5, 1917, the receiver was discharged, and the impounded funds were turned over to the North American Oil Consolidated.

As stated in paragraph 5 on page 4 of the petition herein, the ultimate question for decision in this case is as to whether or no income from oil produced and sold in 1916, impounded in the hands of the receiver during the period February 3, 1916-December 31, 1916, and turned over to the Petitioner herein in 1917, is, under the circumstances of this case, taxable income in 1916 to the Petitioner (which at all times claimed the land from which the money was produced), as was held by the Board of Tax Appeals, or in 1917, as was held by the Circuit Court of Appeals, or in some other year. The answer to this question

*The Pickett Act (36 Stat. 847) contained a proviso reading as follows: "That the rights of any person who, at the date of any withdrawal order heretofore or hereafter made, is a bona fide occupant or claimant of oil or gas bearing lands, and, who at such date is in diligent prosecution of work leading to discovery of oil or gas, shall not be affected or impaired by such order so long as such occupant or claimant shall continue in diligent prosecution of said work."

depends, we believe, upon the answer to be given to certain other questions, and, as we see the situation, such other questions are:

1. Does the income tax law require the **right** to income to be unconditional before the income itself could be properly accrued on the books of account of the Petitioner as accrued income of the Petitioner for the year 1916?

2. Assuming that the Petitioner's basis of accounting was cash and not accrual, was the income paid to it by the receiver in 1917 taxable income to it in that year, notwithstanding the undeniable fact that its **right** thereto did not become unconditional until 1922, when the Government's appeal was dismissed?

ARGUMENT.

I.

UNCONDITIONAL RIGHT TO INCOME IS NOT A CONDITION PRECEDENT TO THE ACCRUABILITY OF INCOME.

We know of no case dealing with this precise question; but in *Lucas v. American Code Company,* 280 U. S. 445—a case dealing with the question of the year in which a loss should be deducted—the Court said:

> "Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains. *Weiss v. Wiener,* 279 U. S. 333, 335. Exception is made, however, in the case of losses which are so reasonably certain in fact and ascertainable in amount as to justify their deduc-

> tion, in certain circumstances, before they are absolutely realized. As respects losses occasioned by the taxpayer's breach of contract, no definite legal test is provided by the statute for the determination of the year in which the loss is to be deducted. The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal test. And the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income." (p. 449.)

Clearly the impounded funds constituted income. *Doyle v. Mitchell Bros. Co.,* 247 U. S. 179, 185, and *Eisner v. Macomber,* 252 U. S. 189, 207. And, in a proper case, they were returnable for taxation upon the basis upon which the taxpayer kept its accounts, if such basis clearly reflected the taxpayer's income. This is so under the provisions of Section 13(d) of the Acts of 1916 and 1917 (Act of Sept. 8, 1916, 39 Stat. 756, c. 463; Act of October 3, 1917, 40 Stat. 300, c. 63) which provides that,

> "A corporation * * * keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned; * * *."

The Commissioner's approved interpretation of section 13(d) was that it

> "will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

See *United States v. Anderson*, 269 U. S. 422, 437, 438, and also at page 440, where it is said that the purpose of sections 12(a) and 13(d) of the Act of 1916

> "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis."

The income represented by the sales of oil in 1916 and which was impounded in the hands of the receiver was from a "fixed and determinable" source, and it was definite in amount. It was in fact accrued upon the books of the Petitioner in the year 1916 and

by amended return for that year, filed in 1918, it was returned for taxation as the accrued income of the Petitioner. Neither the accruability of the income nor the propriety or legality of filing in 1918 the amended return for 1916 was questioned in any way by the Commissioner until 1927, when he affirmatively raised the question before the Board of Tax Appeals. (R. 122-123; R. 46-47; R. 139; and Petition herein p. 8.) At no time did the Petitioner for a moment admit that it was not entitled to Section 2 as against the Government. On the contrary, it contended always, and prevailed in the contention, that it was the equitable owner of Section 2 and, in consequence, of the money realized in 1916 from the sale of oil produced therefrom. This case on its facts is, therefore, the opposite of *Lucas v. American Code Company,* supra, where the taxpayer always denied liability; and it is clearly distinguishable from *Lucas v. North Texas Lumber Co.,* 281 U. S. 11 (cited by the Circuit Court of Appeals), which involved an executory contract to sell land, and in which it was said that a condition precedent had to be performed by the taxpayer before he could lay any claim to the purchase price.

In this case no "condition precedent" remained to be performed by the Petitioner at the date of the filing of the Government's suit to quiet title. All facts were then in existence which enabled the Petitioner to say that it was the equitable owner of the land and the impounded money. The decision of the Court created nothing; it merely declared what the facts meant.

The incident of the receivership should be disregarded as having no effect upon the situation. The receiver was a mere arm of the Court and was invested with no estate in Section 2. *Converse v. Hamilton,* 224 U. S. 243. He held for the Court for the benefit of whomsoever it should at the end of the suit be found to concern, and no rights or titles were changed by his possession. *Grant v. Mutual Life Insurance Co.,* 106 U. S. 429. Suppose, as Judge James supposed in *Obispo Oil Co. v. Welch, Collector,* 48 F. (2d) 872, 875, Southern District of California, that no receiver had been appointed, but that *pendente lite* in 1916 the Petitioner herein had operated Section 2, extracted and sold oil therefrom, but had not actually received the money therefor until 1917 although it had accrued it upon its books as income in 1916. Upon such a state of facts is there anything in the income-tax law which would have precluded the accrued item from being income taxable to the Petitioner in 1916 merely because the Government, the owner of the legal title to Section 2, was challenging by suit the Petitioner's equitable title to the section and to the income produced therefrom? Or suppose that the bill in equity had been filed by a third party and not by the Government. Is there anything in the income-tax law which would have precluded the Petitioner from accruing the item as income in 1916?

If the right to income must be unconditional to warrant its accrual, then it would seem to follow that any quiet title suit, however groundless, filed against the Petitioner herein at the present moment by anybody, however irresponsible, would prevent the Peti-

tioner from accruing upon its books income from the property involved in the suit. It would seem also that any challenge in a lawsuit of a right to income would prevent the income from being accrued. Such a result does not seem to be reasonable. And yet, as we understand the matter, the position of the Government in this case must be that the 1916 earned income was not accruable by the Petitioner for the reason that its right to that income was challenged in litigation instituted by the Government.

We submit that a practical view of the matter is to be taken (*Lucas v. American Code Company,* supra), and that in such a view a taxpayer who consistently keeps his accounts upon the accrual basis should, during litigation over the title to income producing property, continue to accrue the earnings as income, and to return them for taxation as accrued income, year by year as the moneys are "earned" from the property producing them, if the taxpayer was in possession of the property under color and claim of right at the time of the commencement of the suit, as was the case with the Petitioner, and litigates his right to a conclusion, either favorable or adverse to himself.

And on this aspect of the case it is submitted that it is material to know as a fact whether or not the Petitioner herein was upon the accrual or the cash basis in 1916. The fact about that matter was not found by the Board of Tax Appeals. It is true that on the Petitioner's tax returns for 1916 and 1917 the word "Yes" was written in answer to the question of whether the return was made "upon the basis of actual

receipts and disbursements." But there is also evidence in the record, as has been pointed out by both Petitioner and Respondent (R. 24, 67, 68, 72, 169, and 178) that the accounts were kept and the returns filed on the accrual basis. And "whether a return is made on the accrual basis, or on that of actual receipts and disbursements, is not determined by the label which the taxpayer chooses to place upon it." (*Aluminum Castings Company v. Routzahn,* 282 U. S. 92, 99.) The impounded funds issue was not asserted in the Commissioner's sixty-day letter. It was asserted as an affirmative defense in the Board proceedings and was not and is not clothed with any presumption of correctness. The burden was upon the Commissioner to prove that the taxpayer was not upon the accrual basis (*Brunton v. Commissioner,* 42 F. (2d) 81, 82), and he failed to carry it. If the basis upon which the Petitioner kept its accounts is material, as we submit is the case, the proceeding should be remanded to the Board of Tax Appeals for complete findings. Compare *Universal Battery Co. v. U. S.,* 281 U. S. 580, 584.

II.

IF UNCONDITIONAL RIGHT TO INCOME, AND NOT CLAIM UNDER COLOR OF RIGHT, IS AT THE FOUNDATION OF THE RIGHT TO ACCRUE, THEN IT WOULD SEEM TO FOLLOW THAT UNCONDITIONAL RIGHT AND NOT MERE CLAIM OF RIGHT TO INCOME MUST EXIST TO RENDER IT TAXABLE AS CASH INCOME.

If the Court should hold that the right to income must be unconditional to justify its accrual as in-

come for a given year, then it would seem to follow that the right to income must be unconditional to warrant or justify including the income in cash income upon the cash basis of accounting. Any basis of accounting is permitted under the income-tax laws in force since the Revenue Act of 1913, if it correctly reflects income. (*United States v. Anderson,* supra.) In the case at bar it cannot be doubted that the impounded funds were income—produced by capital, severed from the capital which produced them, and made available for use apart from that capital. (*Eisner v. Macomber,* supra.) The only question is as to the year in which the income is taxable; and the answer to this question does not turn upon the nature or character of the fund but upon the nature or character of the right to it. If this analysis is correct it would seem to follow irresistibly that upon either the accrual basis or the cash basis of accounting the nature or character of the right to income must be the same to justify its inclusion in the category of taxable income. And so, it would seem, if the right to income must be unconditional to warrant or justify the accrual of the income in a given year, then we submit that the right thereto must be of precisely the same character to warrant or justify the inclusion of the income as taxable income on the cash basis of accounting.

Assuming that the Petitioner was on the cash basis of accounting, if the above analysis is correct the mere fact that the Petitioner actually received the impounded funds in 1917, even under a claim of right thereto asserted at all times during the litigation, was

not enough to make the funds taxable cash income. The event (the dismissal of the litigation by the Supreme Court) which definitely determined the Petitioner's right to the funds did not happen until 1922, and it was not until then that the Petitioner's right to the funds became unconditional. This view of the situation is supported by two cases, *Kentucky & Indiana Railroad Co. v. Commissioner,* Circuit Court of Appeals for the Sixth Circuit, decided December 18, 1931, 54 F. (2d) 738, and *Brown v. Commissioner,* Circuit Court of Appeals for the First Circuit, decided December 17, 1931. (See Appendix B of **Memorandum for the Respondent** herein, where the opinion will be found.)

In the *Kentucky & Indiana Railroad Company* case, supra, the taxpayer contended that certain tolls collected by the Director General of Railroads on a bridge owned by the taxpayer company, were owned by the taxpayer company and in fact and for taxation were allocable to the federal control years, the taxpayer having kept its accounts upon the accrual basis. The dispute between the Government and the Company over the ownership of the tolls was settled by compromise in 1923. The Board of Tax Appeals decided that the tolls and interest thereon were taxable income in 1923, the year in which the taxpayer's right was definitely determined. The Circuit Court of Appeals said:

> "Petitioner, however, insists that the tolls having been collected in the federal control years and the interest having accrued during the same period these items for tax purposes should be allo-

cated to those years, instead of 1923, the petitioner having under the direction of the Interstate Commerce Commission kept its books upon the accrual basis. But the obstacle is that there was no acknowledgement or determination of liability on the part of the Government for either tolls or interest until the settlement in October, 1923. Petitioner made no demand for either tolls or interest during federal control. It did not place these items upon its books or return them as accrued income in the federal control years. This omission was not the result of oversight. It arose from the uncertainty petitioner entertained as to its duty to return the items for those years. This is significant inasmuch as the burden was upon petitioner to establish before the Board of Tax Appeals that the Commissioner should have allowed them for those years. See *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 366. The tolls were omitted from the original claim presented to the Director General. Neither the tolls nor interest items became the subject of negotiations until June, 1923, when liability for each was vigorously disputed. We think that the event which definitely determined the Government's liability for either tolls or interest was the settlement in October following and that the taxable income in question arose then and not previously. See *Lucas v. American Code Co.*, 280 U. S. 445, 449; *Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115, 120; *Bauer Bros. Co. v. Commr.*, 46 Fed. (2d) 874, 876 (C. C. A. 6). These cases deal with expense rather than income items but the applicable principle is the same. See also *U. S. v. Anderson*, 269 U. S. 422, 441; *Burnet v. Sanford Brooks Co.*, supra. Until the settlement it could not be

known how petitioner would fare as a result of Government operation.

The decision of the Board of Tax Appeals is affirmed."

It is submitted that the principle applied in the *Kentucky & Indiana Railroad Company* case should be applied in the case at bar, certainly if the Petitioner was on the cash basis of accounting, unless that case is distinguishable on the ground that the railroad company made no claim to the tolls until after the federal control years, whereas the Petitioner herein always claimed the impounded funds. But such ground of distinction is, we submit, without substance if the Court should hold that the right to income must be unconditional to justify the accrual of income in a given year.

In the *Brown* case (see **Memorandum for the Respondent** herein), one of the questions was as to whether or not the profits of Brown & Adams "from handling the 1918 wool clip as licensed dealers under certain Government regulations was income received in 1918." The partnership of Brown & Adams kept its accounts on the accrual basis. During a part of 1918 and 1919 it did business as an approved dealer on a permit from the Wool Division of the War Industries Board under regulations providing that the partnership was entitled to compensation for distribution services in an amount equal to four per cent of the selling price and was required to dispose, as the Government decided, of all gross profits (including the 4% commission) in excess of 5 per cent of the

"season's business." In February, 1919, Brown & Adams set up an account entitled "Whom It May Concern," which was composed of the excess profits from the "season's business." The Commissioner refused to allow the entire amount of the excess profits as income in 1919, but divided it between 1918 and 1919. "A material amount" of the 1918 wool clip was not sold until 1919. At the end of 1918 the partnership entered on its books as its profits for 1918 5 per cent of the sales of wool in that year to eight accounts shown on its books. Further sales of the 1918 clip were made in 1919, and the eight accounts were closed. In computing the excess profits, the 5 per cent was subtracted from the net profits and the remainder, $253,254.77, was taken to represent the excess profits on the 1918 clip, whether the wool was sold in 1918 or 1919. Certain charges being disallowed the excess profits were increased to $268,947.16. The Government, in 1922, sued for the payment to it of the entire amount of excess profits so set up for 1918, but lost the suit. The partnership finally received as net profits in handling the 1918 clip more than $500,000, although in making their tax return for 1918 they reported but $229,655.67, that being the maximum amount they were entitled to retain under the regulations of the War Industries Board, calculated at 5 per cent of the gross sales. The Commissioner revised the taxable income by allocating to 1918 "that proportion of the total profits which gross sales for that year was of the gross sales for the entire season"—"spring to spring." Further revision was made with the result that the actual profit on the

wool for 1918 was determined to be $504,950.79. (See 18 B. T. A. at p. 862.)

The Board of Tax Appeals (18 B. T. A. at p. 866) reasoned that the excess profits were legally the income of the partnership in 1918, and says:

> "Our holding would be the same, even if full force were given to the wool regulations, for they in terms recognize rightful receipt of the profits by the partnership and purport only to control disposition thereafter. * * * A mere constraint on their disposition by reason of a possible future contingency does not reduce either gross or net income. * * * Since the wool regulations have been without force to take from petitioners any part of their profits, or to impose them with a trust for the Government, such profits must be regarded as having accrued to petitioners irrespective of the regulations or resulting litigation."

As to this the Circuit Court of Appeals held that the accrual as income of 1918 of 5 per cent of the profits on sales made on the 1918 clip, regardless of when the sales were made, was proper, but that the Commissioner was wrong in attempting to include in 1918 income the excess profits above 5 per cent. This holding, that the profits in excess of 5 per cent were not income in 1918, rests, we believe, upon the theory that the right to the excess profits had not become fixed and determined until the termination of the litigation in which the right to the excess profits was being challenged. If that is the basis of the decision, then the case supports and is not contra to the proposition that, in the case at bar, the Petitioner being on a cash

basis, the impounded funds were not taxable until 1922. And, of course, it seems to be clear that the *Brown* case is direct authority for the proposition that, the Petitioner being upon the accrual basis, in possession of Section 2 under the invitation extended by the mining laws of the United States, having made actual discovery thereon prior to the commencement of the Government's quiet title suit, and having continuously and at all times claimed the land and the production thereof, the income of 1916 was properly accruable in 1916, although it was subject to the contingency that the Government might win the suit.

It is accordingly submitted that, if the Petitioner was upon the cash basis of accounting, the mere receipt of the impounded funds in 1917 was not alone sufficient to subject them to taxation in that year. And unless it is to be presumed that the Petitioner herein kept its accounts upon the cash basis, this proceeding should be remanded to the Board of Tax Appeals for complete findings. *Universal Battery Co. v. U. S.*, supra.

III.

NONE OF THE CASES RELIED ON BY THE CIRCUIT COURT OF APPEALS SUSTAINS THE POSITION OF THAT COURT THAT IRRESPECTIVE OF THE ACCOUNTING BASIS THE IMPOUNDED FUNDS ARE TAXABLE IN THE YEAR IN WHICH THEY WERE RECEIVED.

When properly considered, we believe that *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, which is relied on by the Circuit Court of Appeals, does not stand for the principle that income is taxable when received

regardless of the accounting basis upon which the taxpayer keeps his books of account. In that case it appears that the Court did not hold, nor did Sanford & Brooks Company assert, that the taxpayer had ever filed returns in compliance with the regulations or Section 212 (b) of the Revenue Act of 1918 (p. 366). The taxpayer's contention was, not that the money awarded by the judgment of 1920 was taxable income in some specified year, but that it was not taxable income in any view for the reason that the net profit contemplated by the statute as taxable "can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion" (p. 363). In other words, the taxpayer's contention was that inasmuch as its dredging job did not yield a net profit when considered as a whole, there was nothing to return for taxation in any year. The Court held, however, that the revenue act taxes annually the net income resulting from all transactions within the tax year and that income derived from any source within the tax year must be included in the gross income of that year. It is true that the Court said (p. 363) "the recovery made by respondent in 1920 was gross income for that year." And it is also true that it was in that year, 1920, that the right of the taxpayer to the income became fixed and determined. Inasmuch as it does not appear whether the taxpayer was on the accrual or the cash basis, and inasmuch as it does appear that the taxpayer's right to the income became fixed and determined in 1920, the *Sanford & Brooks Company* case does not appear to support the view of the Circuit Court of Appeals

herein that income is taxable when actually received irrespective of the basis upon which a taxpayer keeps its books of account. Rather, it directly supports the Petitioner's contention that, as to a taxpayer on he cash basis of accounting, income though actually received cannot be taxable until the right thereto becomes fixed and determined.

So far as the *Sanford & Brooks Company* case dealt with amended returns it indicated that they should be rejected because there was upon the facts of that case no basis for offsetting the income received in 1920, when the right to it had become fixed and determined, against the losses sustained under the dredging contract in 1913, 1915, and 1916, the income being returnable on the basis of fixed accounting periods and the company having failed to exercise its option to make its tax returns on the long term basis. But in neither the case at bar nor the *Sanford & Brooks* case was it a question of whether or not the amended return was based on hindsight. Clearly in the case at bar the question is whether or not the income can be properly reported on the basis set forth in the amended return.

To the point that income "is ordinarily taxable only when it is received" the Circuit Court of Appeals cites and relies on (R. 203) *Herold v. Mutual Benefit Life Ins. Co.*, 201 Fed. 918; *Maryland Casualty Co. v. U. S.*, 251 U. S. 342; *Eisner v. Macomber*, 252 U. S. 189, 207; *Eckert v. Burnet*, 283 U. S. 140; *Lucas v. North Texas Lumber Company*, 281 U. S. 11; and *Commissioner v. Garber* (C. C. A. 9), 50 F. (2d) 588; but

it seem that none of these cases is in point on the precise question involved in the case at bar.

The *Herold* and *Maryland Casualty Company* cases arose under the Excise Tax Act of 1913, and it was held in the first that tax returns under the 1909 Act should be made on the cash receipts basis, and in the second that both the 1909 and 1913 Acts are based on the receipts and disbursements theory and tax returns thereunder must be made on the cash receipts basis. As pointed out in *United States v. Anderson*, 269 U. S. 422 (see page 439), Section 13(d) of the Revenue Act of 1916 which provides for return upon the basis upon which the taxpayer's accounts are kept, if it clearly reflect income, "did not have its counterpart in earlier legislation." Moreover, neither of the cases dealt with the question of the nature or character of the right to income which permits it to be accrued and taxed in a given year or which permits it to be entered as a cash receipt and taxed in the year of its receipt.

Eisner v. Macomber, supra, the stock dividend case which arose under the Revenue Act of 1916, 39 Stat. 756, c. 463, did not pass upon the questions involved in the first and second points argued in this memorandum. It is, of course, true that the majority of the Court said that gain or profit must be "received or *drawn by* the recipient (the taxpayer) for his separate use, benefit and disposal" to answer the description of income. (See p. 207.) But that was said in the particular circumstances of that case. Moreover, if the words are to be understood literally they

support the Petitioner's second point herein, that in this case the mere receipt of the impounded funds in 1917 did not render them taxable cash income for that year for the reason that the right to them did not become fixed and determined until 1922 when the litigation over that right was terminated.

The case of *Eckert v. Burnet,* supra, concerns a taxpayer who claimed a deduction from income of $22,400 as a bad debt. He made his tax return on the cash basis. (p. 141.) He had been liable as endorser of the promissory note of an insolvent maker, and he substituted his own note for the one which he had endorsed and then marked the endorsed note paid. It was held that the taxpayer was not entitled to deduct the amount of the endorsed note as a debt "ascertained to be worthless and charged off within the taxable year," for the reason that it was not definitely ascertained in 1925, the year of the transaction, that the taxpayer would sustain the loss in question. In other words, to express the matter in the terms we have been using in this case, the taxpayer's loss had not become fixed and determined in 1925. It did not become fixed and determined until he paid the note.

Lucas v. North Texas Lumber Co., 281 U. S. 11, has already been mentioned above. It dealt with an executory contract for the sale of land which could not have become an executed contract until the taxpayer had prepared the papers which were necessary to enable it "to effect the transfer or make tender of

title or possession or demand the purchase price in 1916," and therefore the accrual of the purchase price as income in 1916 was not permitted. The case seems to stand not for the proposition that income is ordinarily taxable when received, but for the proposition that, as to a taxpayer upon the accrual basis, money cannot be accrued as income until the right to it has become fixed and determined.

In the case of *Commissioner v. Garber* (C. C. A. 9), 50 F. (2d) 588, it appears that the taxpayer and certain associates had sold oil and gas leases to the Garfield Oil Company for 200 shares of that company's stock of the par value of $20,000. The 200 shares were half of the company's outstanding stock, and of them the taxpayer received 75 shares. In December, 1918, the taxpayer and his associates entered into two contracts as to which the Circuit Court of Appeals said (p. 589):

> "Taken together, and construed in the light of the negotiations that preceded their execution, the contracts clearly establish that the entire purchase price to be paid to Garber (the taxpayer) and his associates for their Garfield leases was to be $3,000,000. Of this amount $500,000 was paid in cash by the Exchange Oil Company, a subsidiary of the Sinclair Company, and the balance was to be paid out of the income from the certificates, with the ultimate guaranty of outright purchase by the Sinclair Company, on December 14, 1923, of the 200 oil and gas certificates."

The $500,000 was paid in cash in December, 1918, and the balance of the purchase price of $3,000,000 was paid out of the receipts from the certificates.

As stated by the Circuit Court of Appeals (p. 589), "the controlling question of law presented in this case is whether or not the 'income' derived from the sale of the Garfield oil stock, under the two foregoing agreements of December 14, 1918, was income taxable in its entirety in 1918, or was distributable according to the sums received from the certificates during the intervening years, up to and including 1923." The Commissioner contended that "the tax became due as the various payments were received, from year to year." The taxpayer computed his income and filed his returns for 1918 to 1923, inclusive, upon the cash receipts basis and claimed deductions for depletion, which were disallowed by the Commissioner. But in 1925, the statute of limitations having then run against a reassessment by the Government, the taxpayer filed an amended return for 1918 in which he claimed that the "profits from the sale of the taxpayer's interest in 75 shares of the capital stock of the Garfield Oil Company was income for the calendar year 1918, and not for 1919," and that the Commissioner erroneously included said income in the year 1919.

Inasmuch as the taxpayer was on the cash receipts basis, the Court held that he could not accrue in 1918 the profit derived from the sale of his stock, the payments therefor having been made year by year. This

view, says the Court (p. 591), "precludes the possibility of a sudden change of theory after the statute of limitations has run."

We do not see that this *Garber* case militates against any position thus far advanced by the Petitioner in the case at bar. The North American Oil Consolidated accrued the impounded funds upon its books as income for 1916 and it filed its amended return for 1916 long before any statute of limitations had run against the right of the Government to reassess for 1916. There was, therefore, no "sudden change of theory after the statute of limitations has run."† Moreover, it appears in the *Garber* case that the right of the taxpayer to the money representing his profit on the sale of his oil leases was at all times fixed and determined. And so the *Garber* case does not seem to be contra to the second point advanced in this memorandum by the Petitioner herein.

CONCLUSION.

It is submitted (1) that if the basis of accounting is material to a decision herein, this case should be remanded to the Board of Tax Appeals for findings upon that issue; and (2) that if it is to be presumed that the Petitioner was upon the cash basis of accounting, the impounded funds did not become tax-

†At the earliest the bar of the statute of limitations would have fallen in 1921. See section 1322, Revenue Act of 1921, Act of November 23, 1921, 42 Stat., c. 136. The amended return, together with a letter of explanation, was filed March, 1918, (R. 122) and a revenue agent made an examination of Petitioner's books in 1920 (R. 123).

able income by virtue merely of their receipt, but that they were not taxable income until the Petitioner's right to them had been finally fixed and determined.

Dated, San Francisco, California,
March 5, 1932.

Respectfully submitted,

HERBERT W. CLARK,
Attorney for Petitioner.